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¶1. (U) Sensitive but unclassified. Not for public Internet.

¶2. (SBU) SUMMARY: The Ambassador toured the supergiant oil fields Tengiz and Kashagan on November 11 and 12 respectively, discovering in the process new facts about future production, transportation options, public perceptions, labor relations, and government pressure at these two mega-projects. END SUMMARY.

TENGIZ OIL AND GAS PRODUCTION

¶3. (SBU) According to Todd Levy, General Director of Tengizchevroil (TCO), the Tengiz and Korolev oil fields currently hold about 12 billion barrels of recoverable oil; only 6 billion barrels are covered in the current concession agreement with TCO, which expires in 2032. Levy reported that in 2008, TCO had $7 billion in earnings, paid $5.5 billion in taxes and royalties to the Government of Kazakhstan, and spent $1.2 billion on Kazakhstani goods and services.

¶4. (SBU) TCO's Levy estimates that, if the company's third generation Future Growth concept is approved, Tengiz could produce up to 1 million barrels per day by 2014. He said, however, that national oil company KazMunaiGas (KMG) has not yet approved the Future Growth concept, which would require the partners to invest dividend payments in infrastructure improvements, reinject nearly all of the field's associated gas, and forego the revenue from natural gas sales for the time being. TCO's other consortium partners, ExxonMobil and LukArco, have approved the Future Growth concept.

¶5. (SBU) TCO exports up to eight billion cubic meters (bcms) of natural gas each year, which it sends through the Central Asia-Center gas pipeline (majority-owned by Gazprom) from Kazakhstan to Russia and then to Ukraine for domestic consumption (Gazprom will not permit transit shipment to Europe). TCO produces another two to three bcms of natural gas, which it sells at below-market rates to the government. "We supply all of the gas to western Kazakhstan," said Levy. In addition, according to Levy, TCO produces 25,000

British Thermal Units (BTUs) a day of butane and propane, which it ships by rail through Russia to the Black Sea port of Novorossiysk.

KASHAGAN INITIAL PRODUCTION LOWER THAN EXPECTED

¶6. (SBU) Richard Fritz, Public Relations Manager for AgipKCO, the lead operator of the Kashagan consortium, surprised us by saying that Kashagan will not produce 1 million barrels per day (bpd) of crude "before the end of the next decade." He told the Ambassador that first commercial oil production will be 75,000 bpd on December 1, 2012. Fritz also disclosed that although AgipKCO plans to reinject 80-90% of the associated gas, the company will export up to 8 bcms of natural gas per year.

¶7. (SBU) The size, complexity, and scale of the onshore and offshore operations at Kashagan continue to amaze even the seasoned observer. For example, to construct its onshore processing facility, AgipKCO used six times the amount of steel used to construct the Eiffel Tower. The facility has 70,000 tons of pipe in a pipe rack 1.2 kilometers long and six stories high. And each of its three onsite storage tanks, built locally by MontazhSpetsStroi, holds up to 500,000 barrels of oil. AgipKCO has also invested more than $250 million in local infrastructure, including water, power, gas, roads, and a rail line used to ferry workers to and from the onshore plant. After touring the extensive onshore facilities and offshore drilling islands, it is almost possible to understand how such a project could cost upwards of $38 billion -- for the first phase alone.

EXPLORING ALTERNATIVE TRANSPORTATION

¶8. (SBU) TCO's Levy said that the delays in expanding the capacity

of the Caspian Pipeline Consortium (CPC) pipeline to Novorossiysk have led TCO to pursue other transportation options for new production, such as increased rail shipments through Russia and through the Caucasus. Currently, TCO ships two-thirds of its expanded crude production (approximately 210,000 barrels per day) through Russia to Odessa by rail and one-third (100,000 bpd) via 12,000 deadweight-ton, double-hull tankers to Baku, then by rail through Azerbaijan and Georgia to Batumi or Kulevi. TCO currently uses 8,200 rail cars to transport its crude, but negotiations are underway to increase the number to 11,000.

¶9. (SBU) When asked about the importance of the Baku-Supsa pipeline, Levy said that TCO has no need for it at the moment. "We're fine with the current arrangement," he said. He did confirm that TCO is moving Tengiz crude through the Baku-Tbilisi-Ceyhan (BTC) pipeline, but due to its mercaptan content and concerns about blending Tengiz with Azeri crude, TCO will restrict itself to less than 10% (100,000 bpd) of the total volume of BTC.

ENVIRONMENTAL PROBLEMS AND PERCEPTIONS

¶10. (SBU) Although TCO's environmental standards and performance have been "terrific," according to Levy, the local media have created the misperception that the company is a major polluter and contributes to the environmental degradation of the Caspian Sea's fragile ecosystem. "It's been our biggest battle," he said. "The local press bashes us and we have no recourse, because they're controlled by the local government. Let's face it," he said, "they view environmental issues as an opportunity" to extract rent. For example, according to Levy, TCO has been well within its annual permit for gas flaring, despite a recent increase due to the launch of its sour gas injection plant. Nevertheless, the local government has accused TCO of exceeding its authorized amount and TCO must fight the charges in court.

¶11. (SBU) Levy also said that TCO has invested significantly in scientific studies, monitoring technology, and expert advisors to monitor air, soil, and water quality, but that has not alleviated the pressure from the local press or the local government, even when the environmental protection work is carried out together with the Ministry of Environment. TCO Operations Manager Tim West said that local NGOs invited to tour Tengiz have subsequently written

"inflammatory" letters accusing the company of unsafe practices. He also claimed that local media routinely ignore positive environmental reports, such as the World Health Organization's 2008 World Health Report, which notes improvements in longevity, health, and diet for Kazakhstanis.

¶12. (SBU) TCO's Levy does not suspect the involvement of other governments in spreading negative information about TCO's environmental impact, but he did note that environmental fines collected from TCO go to the local government, and he suggested that it therefore has a vested interest in promoting popular misperceptions.

¶13. (SBU) AgipKCO's Fritz echoed the comments of TCO's Levy on the environment, noting that Agip has invested heavily in technology and expertise to monitor and sample air, soil, and water quality since the project began. Nevertheless, AgipKCO receives complaints from the local government and negative press attention on a regular basis.

SULFUR STORAGE AND SALES

¶14. (SBU) TCO continues to produce, store, and sell significant quantities of sulfur, a by-product of the associated gas in the Tengiz and Korolev reservoirs. In fact, Levy estimates that TCO will supply 10% of the world's export market for sulfur by 2017. TCO currently stores eight million tons of sulfur in the open air and will produce 2.4 million tons in 2008. They have sold 1.1 million tons in 2006-2007 and will sell 3.5 million tons in 2008 (or 145% of production). Levy said TCO is committed to moving the

sulfur. "Don't tell the markets this, but we'll sell regardless of price," he said.

¶15. (SBU) Unfortunately, Levy said, it has not been easy to market, sell, or transport TCO's sulfur, particularly because they insist on transparency in the supply chain and sell only to end users. He also confided that the local government regularly pressures TCO to sell the sulfur, and if TCO cannot find its own buyers, the Akimat will provide a list of companies willing to buy, some of them connected to government officials such as Minister of Industry and Trade Shkolnik or KMG President Kabyldin.

¶16. (SBU) AgipKCO's Fritz said they will avoid TCO's sulfur storage troubles by reinjecting 80-90% of the associated gas back into the well and selling the remainder. Any sulfur that must be stored will be palletized and sealed, not crushed, to avoid sulfur dust coming into contact with the atmosphere.

LOCAL LABOR RELATIONS

¶17. (SBU) More than 80% of TCO's 3,500 employees are Kazakhstani citizens, including 77% of all managers and supervisors. Of the approximately 700 expatriate staff, 300 are from Russia or other CIS countries and 400 are U.S. citizens, with another 100 American family members living off-site in Atyrau.

¶18. (SBU) Following a violent clash in 2006 between Kazakh laborers and Turkish supervisors, TCO strengthened the monitoring and oversight of project managers and adjusted the ethnic mix of its workforce, replacing Turkish supervisors with Indian and Filipino managers.

¶19. (SBU) TCO has also promoted local employees to management positions, including three Kazakhstanis who joined the Ambassador for lunch. Two of them have been with the company for 16 years and one, a female health, environment and safety supervisor, has been with TCO for eight years. "We set a standard and an example for other companies to follow," she told the Ambassador.

¶20. (SBU) AgipKCO's Fritz expressed concern about the shortage of skilled local labor and said this issue would become more acute as Kashagan moved closer to commercial production. He was also very skeptical of KMG's ability and capacity to become the lead operator of the Kashagan project as the new agreement signed on October 31

anticipates, saying, "They're like school kids starting out with a Ph.D. program." AgipKCO currently employs 12,000 workers.

GOVERNMENT PRESSURE

¶21. (SBU) Without going into detail, TCO's Levy made clear that the company is besieged by letters, phone calls, and subpoenas from the Atyrau Akimat. He said they employ 15 lawyers to handle corporate cases, and "they are the busiest people in the company," appearing in court every day of the week. "It's killing us to answer these thousands of inquiries," he said.

¶22. (SBU) TCO is less concerned about national legislation and regulations, such as the new tax code and crude export duty. When asked if he thought TCO's contract would have to be approved by a separate act of parliament in order to preserve its tax stability clause, Levy said the draft tax code was modified so that TCO's contract, which was approved by a presidential decree, would not require a separate parliamentary review. As for the export duty, Levy said simply, "We haven't been asked to pay it."

¶23. (SBU) AgipKCO's Fritz was much less cautious in his criticism of the local government. He said the government at all levels considers Kashagan as "a milk cow" and suggested that there is an expectation that government officials involved in the project will "get something out of it for themselves." He said AgipKCO receives 50-60 letters a week from the local government about environmental and other issues. He estimated that 5-10 of the letters require

company lawyers to appear in court. AgipKCO employs two expatriate lawyers and six Kazakhstani lawyers. Surprisingly, Fritz said that having the national oil company KMG as a major equity partner does not help reduce the pressure from the government. "We get no support or assistance from KMG on any of these issues," he said.

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